

APPENDIX

FOMC NOTES - PRF
November 13, 1996

Mr. Chairman:

Since your last meeting, U.S. interest rates have declined as market participants have unwound their expectations for any firming in policy by the Committee in the near term. While the dollar rose early in the period even as interest rates began to decline, in the latter part of the period the dollar lost most of its recent gains.

Turning to the color charts distributed this morning:

Short-term, forward dollar interest rates moved persistently lower in October, particularly following the release of the September non-farm payrolls and then the third-quarter employment cost index.

German forward rates gently declined early in the period but, then, the 9 by 12 -- three-month German rates, nine months forward -- started to back up in late October after comments by Bundesbank directorium member Issing appeared to rule out any further easing in official rates.

Japanese forward rates declined modestly during October but jumped back up last week, after comments by the M-O-F's Sakikabara suggested that the Japanese economy was not as weak as market participants thought. I will return to these comments in a moment.

Turning to the second page:

The U.S. bond market rallied sharply, with the 10-year yield starting roughly at parity with its own 100-day moving average at the time of your last meeting and then dropping over the period to more than 40 basis points under its 100-day average.

German and Japanese bond yields also declined but the net changes over the recent period, since your last meeting, are less striking. German 10-year yields traded back and forth around 6 percent for most of the period, dropping below this level only in the last few days.

Japanese 10-year bonds rallied sharply following the Japanese election. The dominant assumption in the market was that the LDP showing in the Japanese election was only sufficient to ensure that the current macro-economic policy mix would be continued -- that the consumption tax would go into effect, that only a modest supplemental budget would be approved, and that monetary policy would continue to be accommodative -- and that this would bode well for JGBs. Also, weak consumption data, a decline in the leading indicators, and flat price data suggested the continued presence of some deflationary forces. However, the rally in JGBs was largely reversed following Sakikabara's comments last week.

Turning to the third page, you can see that the dollar has lost most of its gains since your last meeting.

Immediately after your September meeting, the dollar rose sharply against both the mark and the yen. Notwithstanding the Committee's decision to leave rates unchanged in September and apparent slowing in the U.S., foreign exchange market participants appeared to focus on the continued prospect for the

U.S. economy to outperform Europe and Japan and, thus, for interest rate differentials to remain in the dollar's favor.

The dollar first started coming off, in mid-October, against the mark -- moving back below 1.53 and 1.52, after Issings' comments.

However, quite significantly I think, both dollar-mark and dollar-yen one-month option volatilities spiked higher on October 29th, the day of the release of the ECI.

While the drop in U.S. interest rates on this day, and thus the changed differentials, may have played some role in the movement in these volatilities, this was just one of a number of events that came together on the 29th.

In intra-day trading in Asia -- which you cannot see on these graphs -- the dollar traded up almost to 115 against the yen but then traded down abruptly following an announcement by the Japanese Ministry of Trade and Industry of a larger-than-expected increase in industrial production as well as comments from a MITI official that exchange rate stability at current levels was desirable and from then-Finance Minister Kubo that current exchange rates reflected fundamentals. These comments led to an abrupt selling of a number of long-dollar positions as traders began to ask whether there had been a change in Japanese exchange rate policy.

Also, October 29th was the day on which the German economic institutes revised up modestly their forecasts for next year's German GDP.

With these developments in the background, as well as market anxiety over whether there would be a change in U.S. exchange rate policy after our election, I think it is easier to understand the impact of Sakikabara's comments last week.

In a newspaper interview he said that the Japanese authorities were not thinking of guiding the yen any lower and that, looking at the fundamentals, it appeared that the phase of the one-way correction of the yen's strength was coming to an end. He added that the market's view of the Japanese economy was overly pessimistic.

Considered in isolation, Sakikabara's comments seem entirely appropriate and, indeed, the Bank of Japan agrees with the substance of his remarks -- both on the yen and the Japanese economy. However, he was pulling himself back from months of aggressively talking down the yen and market participants were quick to recognize the change. All in all, the episode seems a particularly good reminder of the risks of excessive oral intervention.

Briefly turning to our domestic operations, we reached two new lows in operating balances in the banking system, first of 17.2 billion and then of 15.8 billion. While on some low balance days the funds rate has closed on the firm side, the effective fed funds rates have remained fairly well behaved as the banks as well as we on the Desk appear to be learning to adjust to lower balances. During the three maintenance periods completed since your last meeting, the effective fed funds rate has been 5.27 percent, 5.22 percent and 5.30 percent. To address the growing needs in the current and upcoming maintenance periods, we made outright purchases last week of 6.5 billion in Treasury bills.

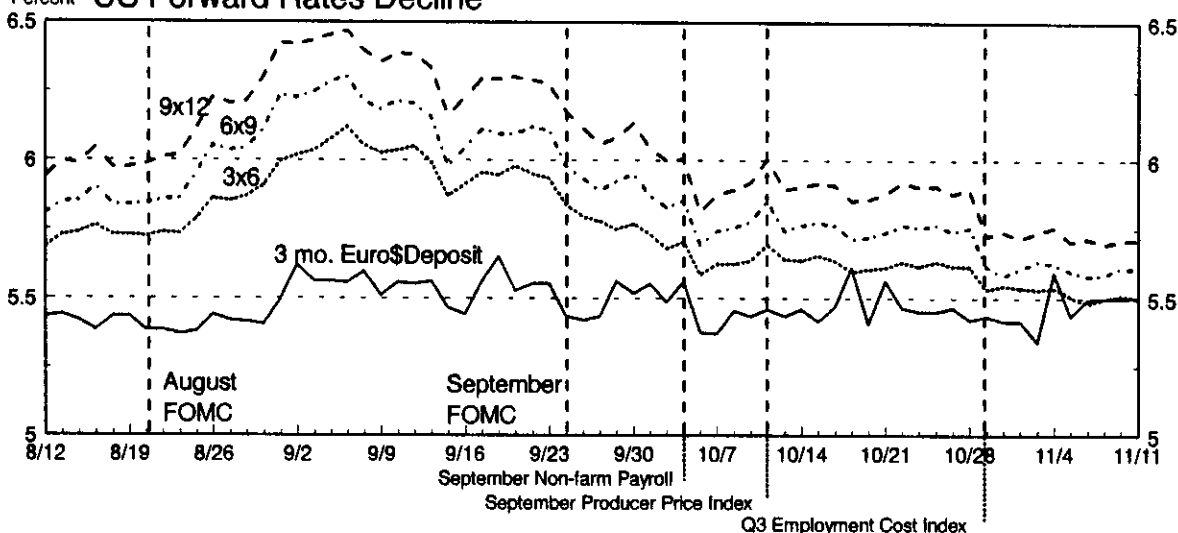
Mr. Chairman, the Desk had no foreign exchange interventions during the period -- oral or otherwise.

As noted in a memorandum from Ted Truman to the Committee, this is the occasion when I need the Committee's approval to renew for one year, without change, the System's swap arrangements with our central bank counterparts and the Bank for International Settlements, including our participation in the North American Framework Agreement with the Bank of Canada and the Bank of Mexico.

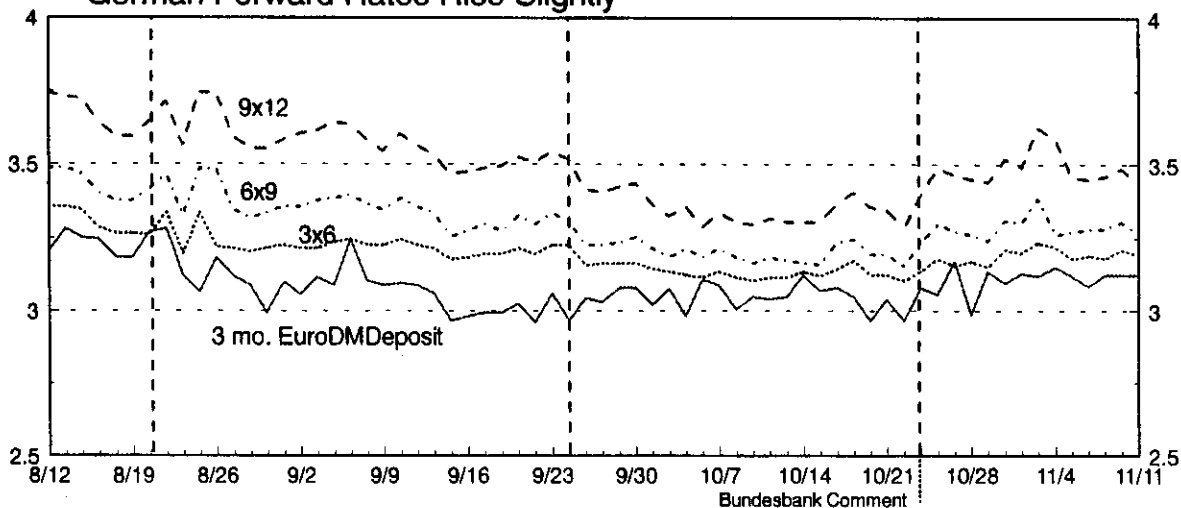
Thus, I will need two votes: one for the Swap arrangements and one for the ratification of our domestic operations. I would be happy to answer any questions.

US Forward Rates Decline

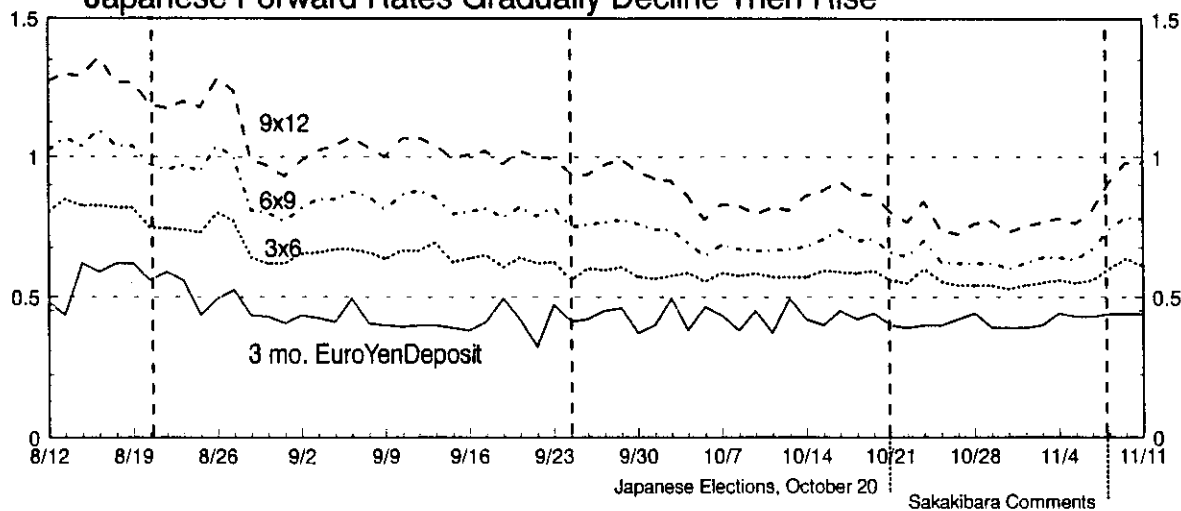
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German Forward Rates Rise Slightly

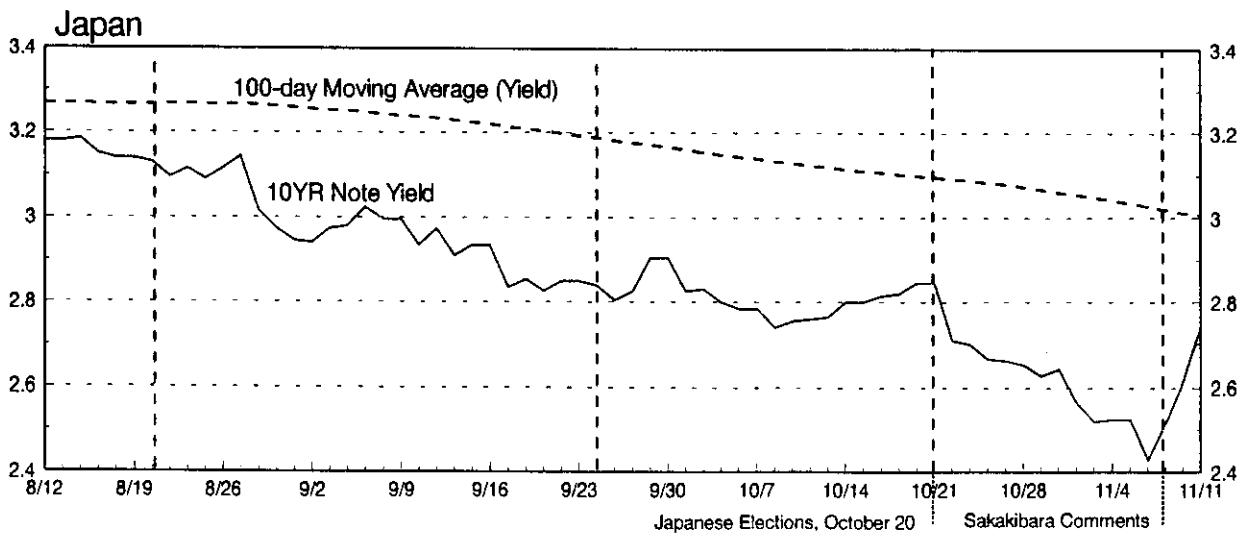
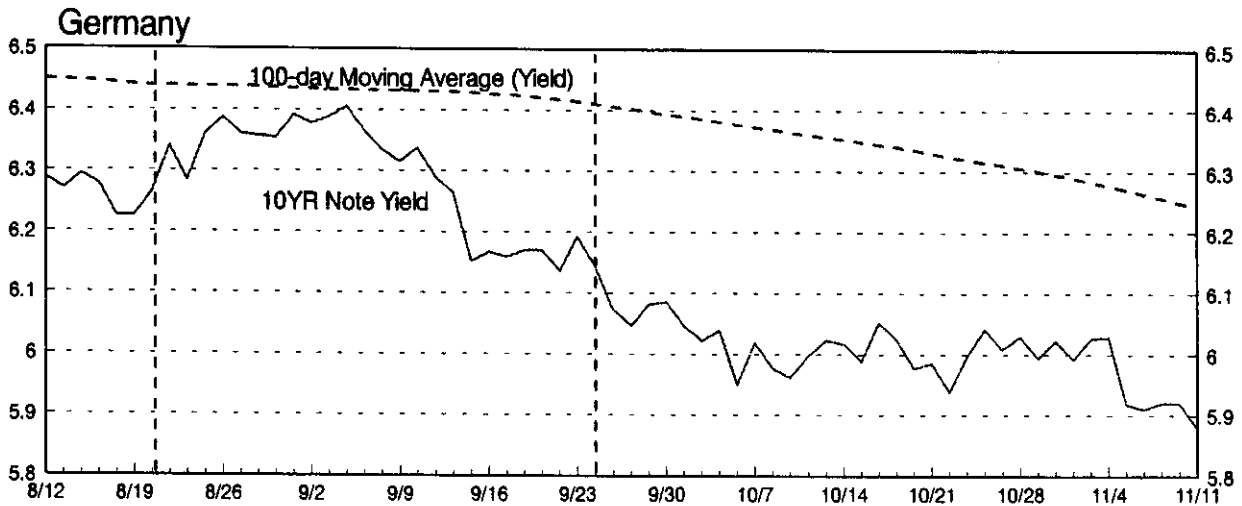
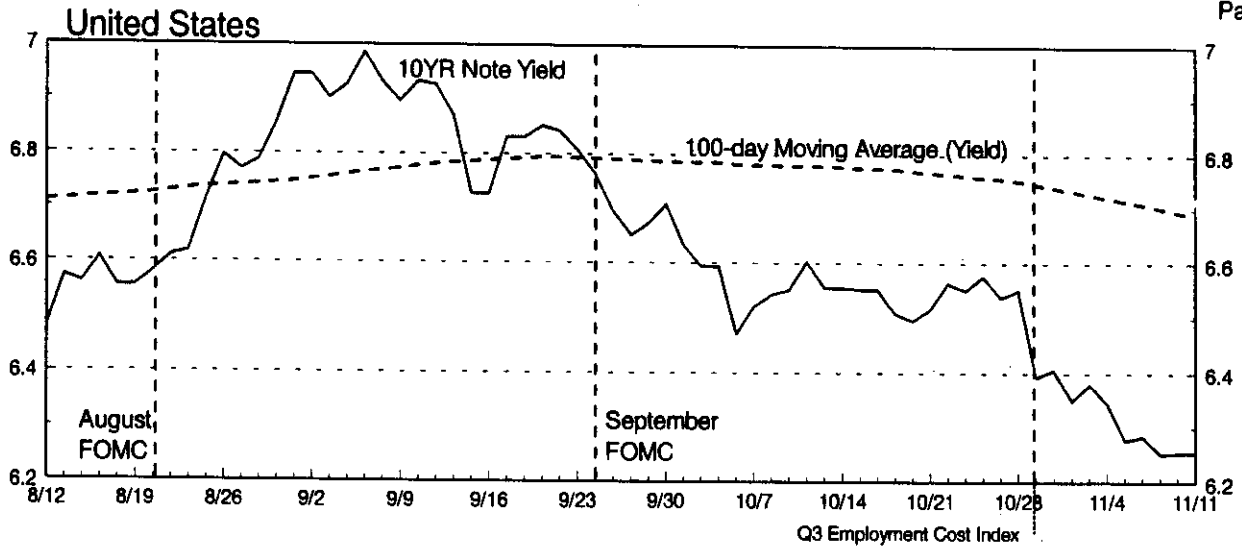


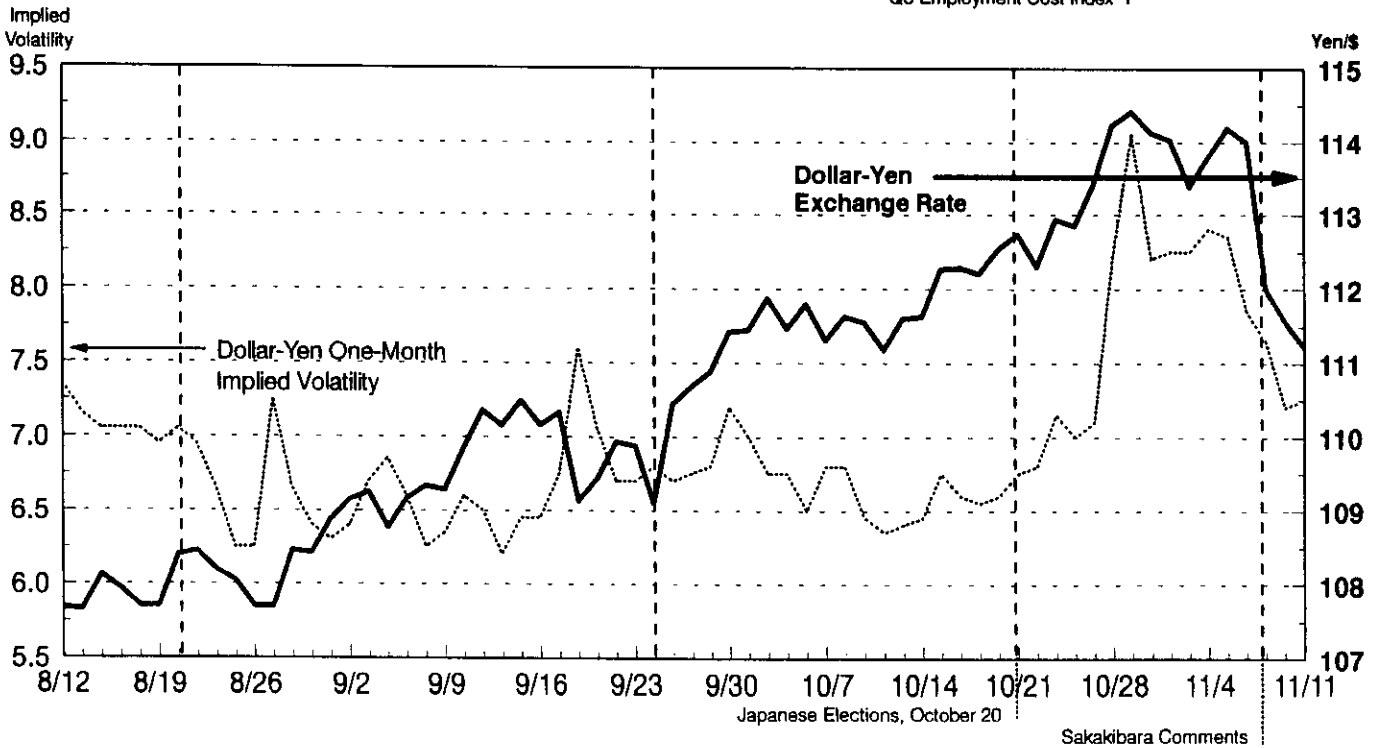
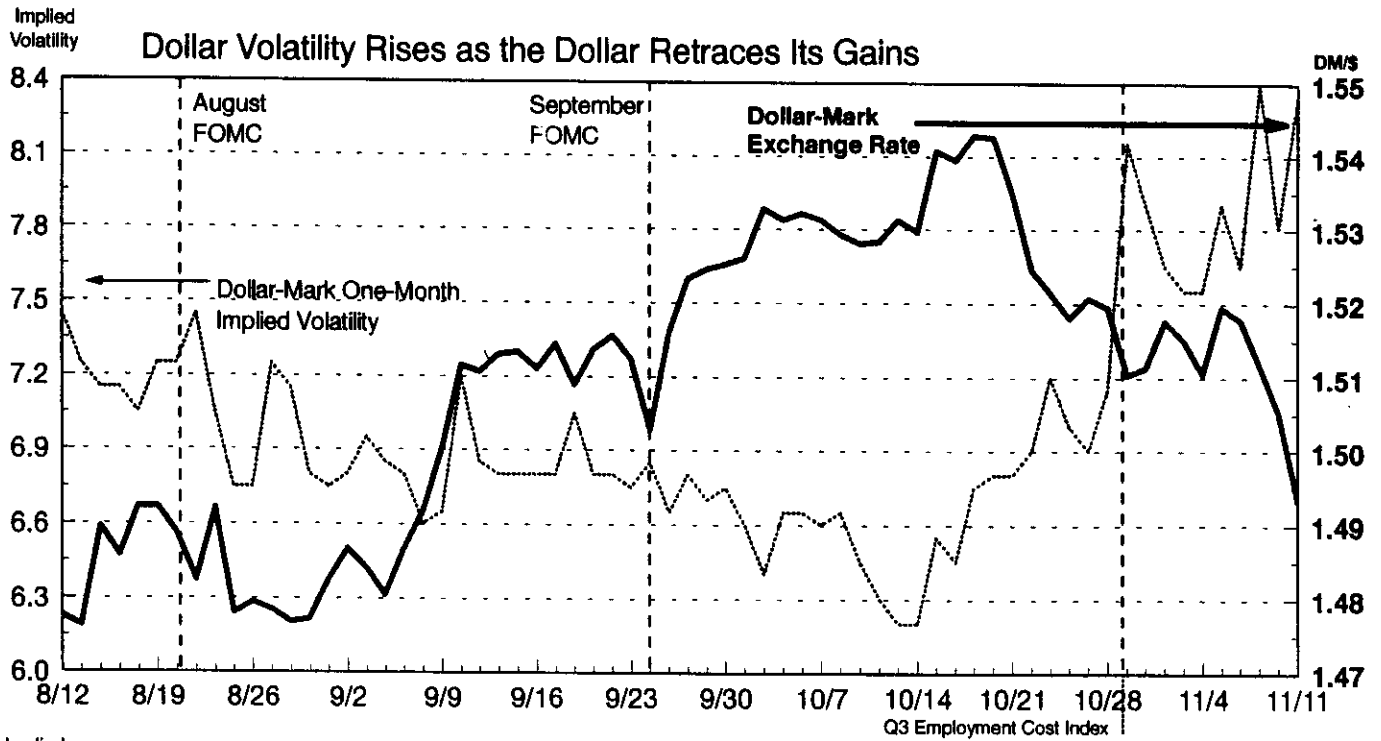
Japanese Forward Rates Gradually Decline Then Rise



G-3 Bond Yields Decline

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Michael J. Prell
November 13, 1996

FOMC BRIEFING

The economic data we received during the intermeeting period contained some notable surprises, relative to our prior forecast. In coming to grips with those surprises in the latest Greenbook, we had to make some tough judgment calls.

The first call related to the prospects for domestic demand in light of the summer weakness in consumer spending and the simultaneous burst of inventory investment. It is our view that the marked softening in spending was a transitory phenomenon--perhaps not even totally a genuine one, given the limited reliability of the data. But even taking the numbers at face value, it must be recognized that real PCE typically moves somewhat erratically from quarter to quarter; statistically, the third-quarter drop-off in growth relative to the recent trend was far from unusual. It was a less-than-one standard deviation departure. Moreover, such deviations from trend historically have had no obvious predictive power with respect to subsequent spending growth. That certainly has been the case with the lulls in sales in the past few years.

But setting aside purely statistical considerations, we see no compelling economic reason to anticipate that consumer demand will lapse into persistent weakness at this juncture. Among the key fundamentals, employment and income trends have remained quite healthy. To be sure, a softening in spending can precede--and potentially cause--a downshift in income. Arguing against that in this case, however, is the fact that consumer sentiment about the economic outlook has remained distinctly upbeat, judging from recent survey results. Moreover, the stock market has continued to

skyrocket, presumably reflecting an optimism about the future and in any event adding substantially further to household wealth.

That said, there are some balancing factors in the consumption outlook; indeed, these have led us to anticipate only a partial reversal of the jump in the personal saving rate recorded last quarter. One is the already heavy investment in consumer durables over the past few years. Of course, this is far from a rigid constraint on spending: While it is a commonplace to talk about the exhaustion of pent-up demand, consumers presumably can always find ways to spend when they have the wherewithal and confidence to do so.

Which brings me to the other negative factor, the consumer debt situation. The thought that spending would be inhibited by household debt burdens has been expressed for some time--and yet spending and borrowing continued to climb. But, now we are confronted with an outright decline in consumer credit in September--one, moreover, that followed some months of reported tightening of lending policies. The full dimension of the September weakening wasn't known at the time we wrapped up our economic forecast, but--given the sizable upward revisions to prior months--it represented no surprise against our anticipation of a considerable third-quarter slackening in debt use.

Because contractions in consumer credit are not the norm in the midst of solid economic expansions, the recent drop does give us some pause; but we aren't inclined to view the thus far brief downturn as compelling evidence that the expansion of consumer spending has run into a roadblock of excessive debt and restricted credit availability. Rather, we think it more reasonable at this point to regard it as further evidence that debt burdens may in fact be one of the influences that have tended to offset the stimulative effect of the

massive rise in net worth that has occurred. I might also note that bond yields in the past few days have been noticeably lower than we anticipate will prevail over coming months; should they not rebound, and certainly should the rally be extended, it would provide a more supportive financial environment for demand. There are already signs of an upswing in mortgage refinancings.

The other important surprise in the third-quarter GDP picture was the size of the jump in nonfarm inventory investment. However, with the receipt of the September figures for wholesale stocks last Friday, it now looks like the buildup may have been appreciably less rapid than it earlier appeared. Even before we saw the latest data, we didn't believe that there was any significant overhang of undesired stocks; it looks still less likely now. Under the circumstances, we are inclined to stick with our projection of a moderate fourth-quarter accumulation, so that the swing in inventory investment should now be a lesser drag on GDP growth in the current period.

The other major surprises of the intermeeting period came from the labor market. First, the unemployment rate remained below 5-1/4 percent, rather than edging back up--this despite the fact that real GDP growth now appears to have run slower than predicted in the last Greenbook. We have carried the lower jobless rate through the projection period. In part, this reflects our guess that output growth over the past year or two has been greater than measured, thereby providing a stronger rationale for the recent level of unemployment.

The second labor market surprise was, of course, the incoming information on wages. The unexpectedly modest third-quarter advance in the ECI for total compensation caused us to lower our estimate of the trend to that point. That was fairly straightforward. Less so

was the reassessment of, in essence, the level of the NAIRU. Looking at the apparent fact that compensation had accelerated only a little this year, in the face of an unemployment rate averaging under 5-1/2 percent, we judged that our previous view of effective labor market slack probably had been too pessimistic. Our current forecast is more compatible with the notion that the effective NAIRU is in the vicinity of 5.6 percent.

Our inflation projection was also lowered by more favorable prospects for food and energy prices going forward. Crude oil prices hopefully have peaked now, albeit at higher levels than we anticipated, and a better than expected corn and soybean crop is being harvested. All told, we're still projecting that maintenance of the current policy stance will yield a gradual updrift in the true underlying trend of inflation, but overall measured CPI increases now are predicted to drop back below 3 percent in the next two years.

There clearly is much more that could be said on these critical issues. But, in the interest of the efficient use of your time, I should stop now and see what questions you have.

November 13, 1996

FOMC Briefing
David E. Lindsey

The data released since the last FOMC meeting have been seen in financial markets as reinforcing the case for leaving the federal funds rate unchanged. The report of a slowdown in economic growth in the third quarter and subdued readings on labor costs and prices confirmed to market participants the desirability of standing pat at the September FOMC meeting and appeared to convince them that the Committee will do so again at this meeting. Indeed, as Peter noted, federal funds futures quotes indicate that market participants have fully removed the prior consensus expectation of policy tightening over the next few months.

The staff forecast, which assumes an unchanged federal funds rate through 1998, has become slightly more optimistic this time about the outlook for wages and prices, even while the unemployment rate going forward has been revised down slightly. In the Greenbook, the economy's expansion is slated to continue at around its potential growth rate, while total CPI inflation is seen as most likely to run a bit below 3 percent over 1997 and 1998. Even so, as Mike and Dave have discussed, some adverse forces on prices are lurking just beneath the surface of the staff forecast. With the economy anticipated to be pressing a little beyond its estimated potential, the staff expects to see a gradual upcreep in labor compensation and underlying price

inflation. However, technical adjustments to the core CPI mask what would otherwise be a considerable acceleration from this year to 1998 with an unchanged policy stance. Thus, while the reported core CPI inflation rate rises only to 3 percent in 1998, this is a misleadingly low figure in the following sense: It incorporates less of an overstatement--by an estimated four tenths percentage point--than we had been accustomed to in the past.

If the Committee were confident in predicting both this gradual upcreep in underlying inflation pressures and the continued low unemployment rate on which that upcreep depends, it might contemplate a policy tightening. Alternatively, the Committee may wish to wait to make sure that the rebound in spending later this year projected by the staff is in fact in train before contemplating a tightening action. Indeed, if the Committee has sufficient concern about weak spending over the intermediate term, it might consider whether the current policy stance is overly restrictive and whether a policy easing at this meeting might be warranted. These three alternatives were discussed in the bluebook, so I won't cover them in detail now. In the event, the Committee may not see the intermediate-term downside spending risks as great enough to justify easing, nor the long-term inflationary risks as certain enough for tightening. If so, the questions remaining on the table today would seem to be: Does the new information on slower spending and lessened inflation pressures justify reverting to a symmetric

directive, or even to an asymmetry toward ease? Or should the bias toward tightening be retained?

I must note at the outset that the issue of symmetry or asymmetry in the directive in one sense is less relevant now than in the past owing to the Committee's evident increased predilection to make policy changes at scheduled FOMC meetings rather than between meetings. To be sure, in exceptional cases of very surprising data, the tilt of the directive still would provide some guidance to the Chairman in considering whether to react to those data.

The bias of the directive, or lack thereof, does, however, retain a role once it becomes public as signalling Committee concerns about the predominant risks to the economic outlook and the direction it is leaning in viewing the likelihood of future policy moves. The bias may occasionally even allow the Committee as a whole to "pave the way" or "set the stage" for future policy action.

Moving to a symmetric directive, or to an asymmetric one toward ease, would seem to need to rest on at least one of two pillars: a sense of greater near-term downside risks to spending or of lesser longer-term inflationary risks than embodied in the staff forecast. Mike has already addressed several notes of caution about prospects for consumption expenditures, including a little decline in consumer credit in September. Moreover, in the November survey, bank loan officers reported more stringent practices for consumer lending over the previous three months.

As for the second possible pillar supporting a case for a change in the tilt of the directive, the Committee might view the staff as being too timid in lowering its estimate of the natural rate of unemployment only a notch.

Maintaining a bias toward tightening would appear to be called for if the underlying inflation outlook were seen to be at least as problematic as in the Greenbook. Using the directive in this way to indicate a vigilant posture against inflation might also seem justified by more widespread anecdotal reports of late of tighter labor markets and intensifying pressures on labor costs. Pressures on labor costs could become still worse, of course, should spending spring back more vigorously than the staff foresees, an eventuality made more probable by the continuing rallies in bond and stock markets.

As a final subject of my remarks, I'd like to give a brief update on the monetary aggregates. M2 expansion slowed in September and October and this aggregate is likely to grow 4 percent for the year as a whole. This pace is further below the 5 percent upper bound of its annual range than we thought in the last bluebook. By contrast, M3 growth has strengthened more than expected of late, and is likely to finish the year around the 6 percent upper bound of its range. But we are not interpreting this latter development as an indicator of robust spending. Rather, it seems to be associated partly with shifting bank financing patterns and, additionally, with a recent-months' surge

in business lending that could be reflecting in part an inventory buildup.